BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
GUSTAV S. AND STELL GOSSICK)

Appearances:

For Appellants: Jerry F. Brown, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gustav S. and Stell Gossick against, a proposed assessment of additional personal income tax in the amount of $1,242.27 for the year 1957.

The question presented by this appeal concerns appellants' tax basis for certain real property which they exchanged and subsequently repurchased.

On November 4, 1953, in accordance with their established practice of acquiring real estate for investment purposes, appellants purchased an unimproved lot in Reseda, California, for $5,100. Several years later Sears, Roebuck and Company indicated, an interest in that lot and adjacent property, and by 1957 it appeared that a profitable sale to Sears was imminent.

In early 1957 Mr., Gossick began negotiating for the purchase of a parcel of unimproved realty located in Canoga Park, California. Its owner, a Mr. Speer, wanted $50,000 for the property, the terms of sale being $14,500 cash and the balance payable over the next two years, as evidenced by a promissory note secured by a first deed of trust on the property.

Appellants contemplated constructing a professional building on the land to be purchased from Speer. In order to obtain a construction loan they needed to acquire the property free of any encumbrance, and Mr. Speer was unwilling to subordinate his first trust deed. As a solution, it was agreed that appellants would exchange their Reseda property for Mr. Speer's realty in Canoga Park, both properties being valued at $50,000 for purposes of the exchange. Immediately after the trade, appellants would repurchase the Reseda lot for $50,000, the terms being $14,500 in cash and a note for $35,500 secured by a first deed of trust.' The exchange and repurchase agreed on were executed August 20, 1957.

In anticipation of the sale of the Reseda lot to Sears, Roebuck and Company, appellants had purchased another parcel of real estate in June 1957, and had given their promissory note for $56,800.' Subsequently they learned that Sears had abandoned its plan to buy the Reseda lot. Recognizing their precarious financial situation, with both notes becoming due in less than two years, appellants sold the Reseda property on December 9, 1957, for $35,750. The buyer paid *no* cash, but merely assumed appellants' obligation for payment of the note to Speer.

Appellants argue that they sustained a capital loss of $14,473.10 on the sale of the Reseda lot.' This result is reached by the following line of reasoning:

When appellants exchanged the Reseda lot for Mr. Speer's Canoga Park property, they recognized no gain or loss on the transaction (Rev. & Tax. Code, § 18081, subd. (a)), and the basis of the Canoga Park property became $5,100, the same as the Reseda property. (Rev. & Tax. Code, § 18081, subd. (d).) The basis of the Reseda property upon repurchase from Mr. Speer was $50,034, its cost to appellants. (Rev. & Tax. Code, § 18042.) The loss on the sale of the Reseda property in December 1957, is recognizable in full (Rev. & Tax. Code, § 18032), and such loss is measured by the excess of appellants' basis for the property ($50,034) over the amount which they realized on the sale of the property ($35,750 less incidental expenses of the sale in the amount of $89.10) (Rev. & Tax. Code, § 18031, subd. (a)), or $14,473.10.

Respondent contends that appellants are not entitled to a stepped-up basis for the Reseda lot as a result of the transactions with Speer on August 20, 1957. Using a basis of $5,100 and treating the property as held for more than two but less than five years, respondent determined that appellants realized a capital gain on the sale of the lot in December 1957, 60 percent of which was taxable under section 18151 of the Revenue and Taxation Code as it read in 1957. Respondent thus computed a taxable gain of $18,276.54.

If each step of the transaction here in question is viewed separately, it is clear that appellants have complied literally with the terms of each of the statutes which they cite. It is an established principle of income tax law, however, that the incidence of taxation depends upon the substance of a transaction, and courts will look through the form in order to determine what really took place. (Commissioner v. Court Holding Co., 324 U.S. 331 [89 L. Ed. 981]; Gregory v. Helvering, 293 U.S. 465 [79 L. Ed. 596].) Where there are a series of steps resulting in a change in property interests, as in the instant case, it is important to determine whether each step should be treated separately for tax purposes or whether the completed transaction is to be viewed as a whole, each step merely constituting an element of a unitary plan to achieve an intended result. (Kanawha Gas and Utilities Co. v. Commissioner,, 214 F.2d 685.)

A test commonly-used in deciding whether a series of steps is to be treated as a single transaction for tax purposes is that of the mutual interdependence of the steps: 'Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series?" (ACF-Brill Motors Co, v. Commissioner, 189 F.2d 704.) Applying this test to the facts before us, it is apparent that neither appellants nor Speer would have agreed to the exchange of properties had there not also been the repurchase agreement. The goal of appellants in this entire transaction was to end up with title to both the Reseda and the Canoga Park properties, while Mr. Speer wanted $14,500 cash plus security for a balance of $35,500. Neither side would have achieved its ultimate purpose had the series of transactions been halted prior to completion.' . . . The net effect was simply a purchase by appellants of the Canoga Park property with the price secured by the Reseda property. . .

The United States Circuit Court of Appeals dealt with an analogous problem in United States v. General Geophysical Co., 296 F.2d 86, cert. denied, 369 U.S. 849 [8 L. Ed. 2d 8]. ... In that case the taxpayer, a corporation, transferred assets to two of its major stockholders in redemption of their stock. Later that same day the corporation repurchased the property from the former stockholders in exchange for corporate notes. The question presented for decision was whether the corporation's reacquisition of the assets resulted In a step-up in the basis of those assets.

In holding that upon reacquisition the assets retained their original cost basis, the court emphasized that in order for a stepped-up basis to be attributed to the assets in this situation, it would be necessary to prove that there

had been a complete severance of the corporation's ownership of the assets prior to their repurchase by the corporation. In support of its finding that no such severance had occurred, the court relied in great part on the facts that (1) the corporation had parted with bare legal title to the property for only a few short hours; (2) its control and use of the property were never interrupted; and (3) even the surrender of its legal title was made under circumstances creating a strong expectation that it would be returned shortly. Neither the existence of a valid business purpose behind the transaction nor the good faith of the parties was as persuasive to the court as the above facts. The court warned: "A new horizon of tax avoidance opportunities would be opened by allowing a stepped-up basis to result from the transaction here effected." (United States v. General Geophysical Co., supra, 296 F.2d 86, cert. denied, 369 U.S. 849 [8 L. Ed. 2d 8], at p. 89.)

Applying the reasoning of the United States Circuit Court of Appeals to this case, any consideration of business purpose or good faith is immaterial in view of the facts that appellants parted with legal title to the Reseda property only for a few minutes, their control and use of the Reseda property was never interrupted, and from the beginning it was known that appellants would immediately repurchase the Reseda property from Mr. Speer. The transaction lacked substance, for income tax purposes, and should not be allowed to conceal what really amounted to a sale of the Canoga Park property by Mr. Speer to appellants for $50,000.

We conclude that respondent properly refused to attribute a stepped-up basis to the Reseda property, and properly utilized appellants' original cost basis in determining the amount of gain realized by appellants upon sale of that realty.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor, . . .

Appeal of Gustav S. and Stell Gossick

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of. the Revenue and Taxation Code, that the action of the Franchise Tax Board *on* the protest of Gustav S. and Stell Gossick against a proposed assessment of additional personal income tax in the amount of $1,242.27 for the year 1957, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of March, 1965, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

, Member,

, Member

Attest: , Secretary